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# Miscellaneous Revenues Report

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Respectfully submitted by David R. Smith  
to the Citizens Finance Review Commission

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## **EXECUTIVE SUMMARY**

The miscellaneous revenues report has several findings and recommendations.

1. The 2003 Governing Magazine report entitled “2003 State and Local Sourcebook” shows Arizona 50<sup>th</sup> out of 50 states for combined state and local per capita fees, fines, and interest charges. This data was collected through the U.S. Census Bureau for the year 2000 census “Governments Finances” report issued in January 2003. When local data is removed, Arizona is 48<sup>th</sup> out of 50. Arizona could collect \$77 million more in fees, fines, and interest earnings and still be ranked 48<sup>th</sup> out of 50.
2. Any adjustment to fees, charges, and interest including indirect costs and internal services charges should be accomplished through an analysis by a professional cost accounting firm, competitively bid. There are several such qualified firms. True actual costs for regulatory, licensing, indirect costs for grants, and internal central services charges should all be developed, as well as a process for further updates for actual costs.
3. Updated fees and charges are subject to a 2/3 vote of the Legislature for FY 2005. Support from the business and regulated communities should be solicited for the simultaneous commitment to higher performance standards and cost discipline by the state regulating and licensing agencies in return for any adjusted fees.
4. Interest earnings can be increased by making deposits more timely and by investing in securities with a longer maturity.
5. The state should move aggressively to stop any revenue leaks affecting the general fund or special funds. Revenue leaks can occur from new out-of-state residents, unlicensed businesses, or the underground economy. The State Department of Revenue should expand its staff to the point of diminishing returns. The public culture should be one of firm, fair enforcement. The state should establish an intra-governmental task group to work on this issue. Included in this task group would be new revenue opportunities from franchises, advertising and naming rights, and other business practices.
6. Miscellaneous taxes make up those sources of funds from economic activities that are taxed for policy reasons. This would include mineral severance taxes, fuel taxes, so-called “sin” taxes on alcohol and tobacco products, lottery, pari-mutuel and gaming proceeds, and industry taxes such as on insurance premiums. These taxes are what is usual or customary for that industry based on similar but not uniform state taxes around the nation. Some taxes are holdovers from “sumptuary” tax philosophies, referred to as luxury taxes.

The recommendation for miscellaneous taxes is that certain selected flat per unit tax rates be updated for inflation. “Updating for inflation” recognizes that

the underlying purpose is updating for actual costs. Failure to do so puts fiscal pressure on the general fund or special purpose funds such as HURF, making general statewide taxes higher than they need to be.

7. All per unit tax adjustments for inflation should be packaged into one statewide voter referendum or initiative, which would also include indexing the state personal income tax brackets.

## **THEORY OF MISCELLANEOUS REVENUES**

There is political and ideological debate about what constitutes a “fee” versus a “tax”. Some believe all fees and charges levied by government are a tax. Often, the so-called “duck test” is invoked -- “Does it look, walk, fly like a duck, etc., then it’s a tax.” Others in the political spectrum differentiate a fee from a tax. That differentiation depends upon the source, purposes, and benefits received from the revenues. In some cases, differentiating a fee from a tax is muddled, at best. The motor carrier “tax” in Arizona was converted to a structured “fee” after 1997, but it still carries more of the characteristics of a tax. Unfocused interchangeable use of these terms can lead to cynicism about what constitutes true fees. A standardization of terminology is helpful.

### **Definitions**

A fee or charge is a dollar amount imposed to pay the costs for a volitionally engaged in activity that carries a governmental interest, or for the use of a public facility. Fees or charges are levied to pay part or all of costs associated with specific activities. The benefit of that use accrues to the user.

Licenses and permits are official or legal permission to do or own a specified thing. Examples include building permits, professional licenses, or game and fish licenses. License permit fees are used to offset the cost of regulatory activity or special public use. The benefit of adherence to societal standards through regulation enhances the public’s perception and credibility of those regulated activities. Regulation of economic activity emanates from the police power and the sovereignty of the state.

A fine is a penalty amount imposed for some kind of civil or criminal wrongdoing. Fines can be judicially or administratively imposed, based on law or regulation, tied to some kind of legal due process. Fine amounts are not based on recovery of the cost of public services, but rather their appropriateness as a sanction for an offense.

Interest earnings are accrued on government accounts by investing generally in conservative, federally backed bank deposit accounts. These funds provide cash flow to pay for government services.

A grant-in-aid is an intergovernmental transfer of funds usually from a larger government to a smaller, for a specific public purpose. The grant-in-aid can require a variety of conditions, including matching resources of a variety of types by the receiving government.

A donation to a public agency is cash, equipment, land, intellectual property, or volunteer time. Donations to government usually invoke federal tax deductible opportunities and usually must also be appropriated by the legislative body.

A surcharge can be a penalty on top of an existing fee, perhaps for late payment. A surcharge can also refer to unbundled specific itemized charges such as

document storage and retrieval, additional business processing, or special reports, in addition to a base fee.

A forfeiture is bonds, cash, or property surrendered to government ownership pursuant to a criminal proceeding.

A tax is a specific financial levy imposed by government on particular economic assets or economic activities. There is usually no specific matching of burdens and benefits. All economic assets and activities in a class are treated in the same way, within constitutional due process. Government can impose criminal or civil penalties and sanctions for failure to comply. Taxes are usually levied to fund government activities that do not or cannot carry their own sufficient revenue sources, i.e., such as primary and secondary education or indigent health care. Usually, taxes are used to support activities not profitable in the private sector. Taxes usually support the general fund and accommodate the funding of dozens of public needs as determined by the state constitution and the legislature.

In lieu taxes are payments made instead of regular taxes on entities that would otherwise be exempt from taxation. An example is the Salt River Project payment in lieu of property taxes to local governments.

**PRINCIPLE I: USE FAIR FEES, CHARGES, FINES, INTEREST, DONATIONS, GRANTS-IN-AID BEFORE TAXES**



In a jurisdiction striving to keep taxes low, all other resource possibilities for the budget should be exhausted fully before going to taxes last. Total revenues should reflect a diligent search for non-tax revenues each year to build a budget dependent as little as possible on general taxes. Assuming taxes burden a particular economic asset or class of economic activity, limiting taxes on those assets or activities disciplines the negative drag on this part of the economy. Economic drag can be defined as price resistance affecting the elasticity of demand, or negatives to enterprise profitability, or adding to the cost of tax administration and compliance.

Thus, the ideal non-tax miscellaneous revenue side of any public budget would look like this:

<b>Funding Source</b>	<b>Amount Raised</b>
Fees and charges	100% of operating and capital costs for all regulated activities and special uses by the public. (Two-tier systems when possible for out-of-staters, i.e., university system to export the tax burden.)
Interest earned	Maximize all interest earnings in all special revenue and general funds, as well as by maintaining reserves at responsible levels. Investment professionals in this field should allocate investments.
Fines	Should be levied fairly and collected aggressively. This is often a weak competency within government. Failure to collect fines leads to scofflawing, uneven enforcement, and poor budget estimations. Fines should be commensurate with the offense and the cost of enforcement. These may contribute positively to the general fund.
Donations and volunteers	Should be encouraged where no undue influence ensues or where a community is aligned to a particular public purpose. Volunteers can help save public costs, but cannot incur liabilities or substitute for licensed staff professionals. Donations are almost always for a specific purpose rather than just to the general fund. Donations cannot be relied upon as a stable revenue source.
Grants-in-aid	Currently, Arizona receives more dollars in federal grants-in-aid than the

	entire general fund—about \$8 billion versus \$6.5 billion. Thus, maximizing federal aid is critical to keeping state taxes low. Maximizing federal aid for legitimate federal mandates or federally lapsed responsibilities, i.e., cost of criminal alien incarcerations, are causes behind which the entire Arizona Congressional delegation should unite. Funding to execute federal mandates is not “pork”. State government should have a specific functional unit, both here and in Washington, D.C., on the constant alert to maximize state aid for core government activities that would otherwise burden the state general funds and general taxes.
State taxes	After all non-tax revenue streams are maximized within their own fairness disciplines and after all spending constraints are imposed, the remaining burden to structurally balance the state budget falls to taxes. Taxes should be consistent, predictable, perceived as fair, easy to comply with, and in rates or percentages as low as possible. Further, state revenues should constitute a “diversified portfolio” to mitigate the economic cycle and reflect the constant restructuring of the economy, almost as an investor would diversify an investment portfolio to support consistent revenue growth potential.

This happens to be the budget-making process used by the Maricopa County Board of Supervisors to build its annual \$2.5 billion budget. The Board of Supervisors has been able to use “taxes last” for several years to 1) pay down all general obligation debt; 2) fund all necessary services; 3) assure stable reserves through the economic downturn; and 4) reduce the overall property tax rate 6% over 8 years and maintain the tax rate at levels that are at or near the lowest in the state.

## **MISCELLANEOUS REVENUES DECLINING AS A BUDGET RESOURCE**

Two different high-level analyses suggest that the State of Arizona is under-utilizing revenues other than general taxes. According to the JLBC "Appropriations Report" for FY 2004 (shown below), 1993 to 2004 miscellaneous revenues declined as a percentage of the State General Fund budget from 14.5% to 4.9%, after correcting for one-time revenues. Indeed, the use of one-time revenues are symptomatic of the state's structural budget imbalance for the current and past two fiscal years. General State taxes picked up much of the difference. If miscellaneous revenue had remained constant as a percentage, an additional \$614 million would have been contributed to the budget from these sources for FY 2004.

General Fund Major Tax Sources as a Percent of Total Base Revenue				
<u>Fiscal Year</u>	<u>Sales</u>	<u>Individual Income</u>	<u>Corporate Income</u>	<u>Other</u>
1994	44.0%	34.5%	7.4%	14.1%
1995	44.1%	33.1%	9.3%	13.5%
1996	45.1%	32.0%	9.6%	13.3%
1997	43.9%	33.1%	11.9%	11.1%
1998	45.3%	35.6%	10.1%	9.0%
1999	45.7%	37.2%	9.7%	7.4%
2000	46.9%	38.9%	9.3%	4.8%
2001	48.3%	37.2%	8.8%	5.8%
2002	46.9%	34.8%	5.7%	12.6% <sup>1/</sup>
2003	49.9%	37.7%	6.5%	5.9% <sup>2/</sup>
2004	49.7%	34.1%	6.4%	9.8% <sup>3/</sup> (4.9% recurring)

<sup>1/</sup> Includes \$547.2 million in one-time revenue enhancements.  
<sup>2/</sup> Includes \$464.9 million in one-time revenue enhancements.  
<sup>3/</sup> Includes \$324.9 million in one-time revenue enhancements.  
Source: Arizona Joint Legislative Budget Committee: FY 2004 Appropriations Report, Page BH-13

Further, according to a report by the U.S. Census Bureau and Governing Magazine, Arizona ranks 48<sup>th</sup> out of the 50 states in collecting fees, charges, and interest. Theoretically, if Arizona collected the median amount per capita of all the states, an additional \$1.463 billion would be collected. The state could collect \$77 million more and still remain 48<sup>th</sup> of 50. This chart does not take into account any changes to state fees made subsequent to the year 2000. The chart is also only as relevant or complete as its baseline data. Therefore, the only conclusion drawn is that Arizona is probably below average among the states in fee assessments and collections. (See appendix 1.)

**Revenue From Fees, Charges and Interest**  
**Schedule Ranks States from Lowest to Highest**  
**Per Capita**

<b>State</b>	<b>Per Capita Revenue</b>	<b>Rank</b>
Nevada	349.87	50
Tennessee	363.54	49
<b>Arizona</b>	<b>397.15</b>	<b>48</b>
Florida	411.52	47
Georgia	418.37	46
Illinois	463.50	45
California	467.91	44
Missouri	475.05	43
North Carolina	479.10	42
Kansas	487.98	41
Mississippi	511.28	40
Texas	514.93	39
Oklahoma	549.44	38
New York	553.80	37
Ohio	565.12	36
Arkansas	566.11	35
Idaho	580.53	34
Colorado	592.64	33
Washington	593.23	32
Indiana	625.10	31
South Carolina	637.28	30
Kentucky	646.52	29
Minnesota	646.91	28
Maryland	649.03	27
Alabama	651.51	26
Iowa	675.19	25
Nebraska	675.79	24
Pennsylvania	704.22	23
West Virginia	709.26	22
Wisconsin	722.11	21
Michigan	741.00	20
South Dakota	743.78	19
New Jersey	754.27	18
Connecticut	782.89	17
Virginia	791.16	16
Louisiana	799.93	15
Utah	819.12	14
New Hampshire	827.43	13
Maine	829.17	12
Massachusetts	862.93	11
Rhode Island	866.36	10
Vermont	890.18	9
North Dakota	970.62	8
Montana	975.09	7
Oregon	1,013.81	6
Hawaii	1,044.66	5
New Mexico	1,075.87	4
Wyoming	1,088.51	3
Delaware	1,752.20	2
Alaska	7,504.81	1

Source: U.S. Census Bureau/Governing Magazine  
Note: State revenue FY 1999-00 (excludes local government)

These broad measures both suggest that the state could take better advantage of miscellaneous revenues. Assuming every dollar is critical to the state budget, keeping fees, charges and fines artificially low means a greater burden on Arizona's general state taxes. A greater burden on the general fund simply means higher taxes than would otherwise be required for a structurally-balanced budget. Fees, fines and interest are a relatively small part of the general fund, yet the aggregate impact of neglecting miscellaneous revenues can be large over the long term.

## **THE “REVENUE STARVATION” THEORY OF GOVERNMENT MEANS TAXPAYERS PAY MORE**

Some fiscal conservatives subscribe to the revenue starvation theory of government, i.e., that the budget can be managed largely from the revenue side. “Starve the beast” and you get smaller government. However, general taxes are the *secondary* effect, not the primary purpose or focus of governance. Failure to aggressively manage and control the spending side leads to deficits, higher borrowing and interest costs, unpredictable and inconsistent tax policies, and fluctuating tax rates. The primary challenge of government is to manage the spending side—to require value for every dollar spent, to assure accountability, and to assure the quality of life of the community, which includes keeping taxes as low as possible as a consequence of good governance. An openly discussed awareness of the actual tax consequences of certain spending proposals can help motivate intensity for certain spending controls during the budget process. However, to throw up one’s hands and say “We can’t trust the legislature not to spend every available nickel,” is to say that the legislature is not a learning organization (from the current deficits), and that best practices regarding planning, revenue estimating, reserve and contingent funds cannot be learned from those states, cities, and counties, who, in fact, do it well.

Not everyone agrees that government should be managed from the spending side. The June 9, 2003 Goldwater Institute Policy Report “The Right Cure for what ails us: A Prescription in Arizona” states on page 7, ***“The commission’s first principle is a great example of putting the cart before the horse. Spending levels should be set once it is determined how much the government has to spend, not the other way around. Arizona families have to live within their means and the government should be expected to as well. When revenues are not sufficient to meet expenditures, the responsible course of action is to reduce expenditures. In fact, Arizona’s government is very far from having exhausted its budget-cutting options. The commission’s principle of sufficient funds, which implies raising taxes, also conflicts with the commission’s principle of economic competitiveness (see Commission Principle #3 below).”***

If that policy were followed, there might not have been any state tax reductions during the 1990’s because all of that high growth revenue would have been part of “how much the government has to spend”. Instead, state officials set aside some funds in a budget stabilization fund (not enough, it turns out), and some revenue was rebated in tax reductions. Those are examples of managing the budget from the spending side, with some amount of planning. They just did not go far enough and lost discipline toward the end of the 1990’s because of policy mistakes.

Some states, with managed long-range planning, escaped with small or no deficits in the current downturn. These policies and techniques can be learned. If they are applied with discipline, then taxes can be held to their lowest possible level, not just in any given year, but over the long run. Adherence to conservative fiscal policies, and a highly diversified revenue base can accomplish the goal of any individual taxpayer paying the lowest amount of taxes over the long run.

### **10-YEAR FINANCIAL FORECAST NEEDED**

Some public entities have been using a 5 to 10-year financial forecast for the past several years. This forecast is updated each year and is part of the budget process. These forecasts are an extremely valuable diagnostic tool to:

- 1) predict any long term structural budget imbalance — gauge whether current spending and revenue decisions are sustainable in the future;
- 2) analyze those dynamic revenue or expenditure items accelerating future budget imbalance;
- 3) creating an “early warning” system to point to earliest action possibilities (deficits were overlooked by the state as early as year 2000);and
- 4) create an important long-term planning tool contributing to economic prosperity.

The state should turn the known volatility of state revenues to its advantage through long-term planning. Volatility should be understood and planned for via the modeling of various economic scenarios for various revenues. These scenarios would depict levels of income, business, and sales taxes at least three growth levels and how the state might respond to each. This would encompass a “likely” budget projection, a “high growth” and “low growth” model. Processes for contingent planning based on actual performance can follow. Making revenues more inter-state competitive should be part of this modeling. In other words, cutting business taxes for competitive reasons should be acknowledged as part of fostering long-range prosperity or the state can plan to “bank” annual revenue growth that exceeds normal trends. Tax cutting in the 1990’s was not pursuant to any articulated, specific economic growth plan. Now the state is in payback mode, borrowing \$400 million with interest (paying \$1.05 or more for a \$1.00 worth of services) for every year this continues. If the state established a goal of having the lowest overall state taxes in the western region in the long run, the state should have a 10-year specific plan on how to get there.

The analytic process must gauge all known public responsibilities on the expenditure side ten years into the future. The spending trends should be low, likely, and high. Those expensive priorities such as education, health care, and corrections can then be broken down into component parts to figure out now how to contain these costs and still provide quality services over the long run. Some initiatives take several years to complete. Problems anticipated several years hence can be ameliorated or avoided.

## **PRINCIPLE II: RECOMMENDATION FOR A MISCELLANEOUS REVENUE CONSULTANTS STUDY**

In 1993-94, Maricopa County experienced a \$65 million operating budget deficit. One of the work products for getting out of that deficit was a “user fees study” conducted by the Harvey Rose Corp. of San Francisco. Each source of miscellaneous revenue was studied in depth, in concert with its market, its customers, state law and county policy. Recommendations were made to the Maricopa County Board of Supervisors for fee increases in the amount of \$20.5 million.

The State of Arizona should consider commissioning a professional user fees study to include changes for services and license/permit rates. This would include fee and fines collections, and an indirect costs study by a professionally qualified firm. A sample list of such firms is enclosed. (See appendix 2.) These firms might even go “at risk” for part of their compensation, based on a percentage of their adopted findings.

Miscellaneous revenue is not just an “easy way to get extra money” into the state coffers. Each revenue source must be carefully considered for its burdens and benefits. In a regulated industry, or for a state license, governmental oversight is a monopoly. Therefore, the oversight function must be fiscally disciplined, exchanging the qualities of prompt cycle time, fairness, and due process to the regulated community in exchange for 100% coverage of the cost of that regulatory or licensing function. Government regulation or licensing should be held accountable by performance standards in exchange for 100% funding by the regulated community. This is happening now in many city and county planning and development departments with the development community supporting higher fees in exchange for timely standards of review.

Costs passed onto the regulated community should be slashed as low as possible consistent with business principles. Creative ways to cut regulatory costs include refining business processes (one stop shops), use of e-government technology, co-location in one building of small diverse regulatory offices with centralized back office staff, (i.e. state boards office plus, recommendations in the FY2004 State budget), and incentivizing staff to save money and reduce costs. In that way, working partnerships are strengthened with regulated and licensed industries.

This results in exchanging value for value in regulation—lean regulatory costs for high compliance by the regulated or licensed community—everyone wins, and government is as small as possible. The so-called 90/10 agencies, with 90% of costs to pay for the regulated community, and 10% to the general fund, should go to 100% of the costs to the regulated community, and zero to the general fund. Operating costs should include all indirect or internal service costs. Capital costs for furnishings and office buildings should be included as well. When the regulated community pays fees directly tied to the costs of their regulation, it will have a strong incentive to scrutinize the spending that drives the fees as well as the performance.



The final benefit of that policy is that many agencies are 100% self-funded. They are immune from future general fund state budget cuts the next time the general fund experiences financial distress.

Part of the discipline of fees and charges is to compare these with similar functions in surrounding states. If these charges are out of line, an analysis and adjustment should be made. Relatively low fees competitively priced because of efficiency is a desirable result.

### **PRINCIPLE III: MAXIMIZE INTEREST INCOME**

A preliminary review of state financial practices yielded the following to ensure that cash is invested timely:

- A study should be conducted of the number and amount of cash transmittals from each fee-collecting department. Infrequent, large dollar transmittals are signs that the frequency of deposits should be increased. This review could be incorporated into the Auditor General's work plan.
- Bank lock boxes should be considered for departments with a high volume of transactions. A lock box can be swept several times a day and allows for interest to be earned immediately instead of waiting for transmittals to the Treasurer.
- Depository accounts should be utilized for outlying areas where daily transmittals to the treasurer are not practical.

To take advantage of higher yields on investments with longer maturities, a detailed cash flow analysis should be conducted to determine the minimum amount of funds that should be invested in low-yield overnight or short-term investments. To allow for longer-term higher yield investments, departments should be required to give the Treasurer advance notice of any large disbursements.

Consideration should also be given to direct a portion of the investment portfolio toward "Blue Chip" companies that contribute to the Arizona economy. This should be possible while still adhering to the conservative investment requirements of A.R.S. Title 35.

#### **Principle IV: The State Should Stop Revenue Leaks-Especially Revenue Via New Residents and New Businesses**

Any organization the size and complexity of Arizona State government with hundreds of revenue sources probably has some “revenue leaks.” That is especially true if departments such as Revenue are not fully funded to their revenue collection potential. The recently announced state tax amnesty program is an admission of revenue leaks. The fact is that a percentage of citizens will refuse to pay parking tickets, court fines, probation fees, park entry fees, or other costs if there is no credible enforcement mechanism. In fact, the culture toward government is often “you are stupid if you pay.” Technology and penalties (withholding car registration renewal) for non-payment of taxes, fines, and fees are a necessary part of any good diversified revenue program. Non-payers raise the net costs for everyone else. Shoplifting and insurance fraud raise the costs for all other customers. The insurance industry claims households pay \$300 per year more in premiums just to pay for fraud. The same effect occurs with collections of government revenues. Part of the review of fees, fines, and specialty taxes should be the review of penalty provisions for non-payment. Included are the resources to keep non-payment and the cost of enforcement low. The public culture should be that these fees, fines and taxes will be paid or penalties will be administered swiftly, fairly, and according to due process.

A strong corollary of revenue leakage is that some of it emanates from new residents and businesses coming to Arizona. These new residents begin using state and local public services immediately, but may not pay state and local taxes or motor vehicle taxes for months. Every day this occurs, it is permanent revenue loss to the state, cities, and counties. The state should provide to each new resident a “Welcome—Here is how to comply with all State Tax Laws” relocation package. This relocation package might include information and state laws on car registration, voting, starting a business, complying with traffic laws, and various tax filings. These should be made available through realtors, welcome wagons, chambers of commerce, tax advisors, and homeowners’ associations. A state tax compliance hot line should also be available year-round. This spin-up of lagging revenues should improve total compliance. A high in-migration state needs to make tax compliance part of new resident assimilation.

Revenue leaks also occur from lack of firm enforcement of state tax laws. Especially pernicious is the underground economy that knows by word of mouth whether state tax laws are being enforced and are even enforceable. The current Department of Revenue (DOR) proposal to add 103 FTE’s to the department along with a targeted tax amnesty program is an excellent start to changing the scofflaw underground.

A return-on-investment calculation for each additional DOR employee can be developed to the point of diminishing returns. The state should be concerned about any perception of a casual or inept attitude about collecting its fees, fines, and taxes, similar to the “broken window” theory of law enforcement.

The state should establish a special task group of DOR staffing, plus the Auditor General, JLBC, and OSPB to look for and close all revenue leaks. Auditors need

to do risk assessments, targeting the highest revenue risks first. Policy-making representatives should be included to:

- 1.) Establish a single, comprehensive inventory of all miscellaneous revenues as part of the state budget process. This single all-inclusive inventory does not currently exist.
- 2.) Create an oversight group to help the professional study firm look at fines, fees, interest, and charges.
- 3.) Create appropriate changes in law or regulation to implement any promising results of this study.
- 4.) Create appropriate new sanctions or penalties for non-compliance with state laws regarding fines, fees, and specialty taxes.
- 5.) Create a better method of estimating revenues from all of these sources over the long run.
- 6.) Look at simplifying many of the tax or fee laws that are often extremely complex, creating both collection and disbursement problems. Certain funds are carved up into several pots of money for various purposes, especially those driven by state voter initiatives — the recent tobacco tax initiative is an example. Putting money into a “purpose pot” does not solve a problem. Again, it manages a problem from the revenue side rather than the expenditure (action/results/accountability) side. Revenue streams should be simple in purpose — supporting a specific function or the general fund.
- 7.) State and local employees who collected certain revenues for the state can be incentivized by making improved collections a variable part of their compensation. Private revenue collection companies can be employed and incentivized as well to improve state fee and fines collections. The concept is a form of gain-sharing.

Revenue leaks can also occur from failure to maximize revenue opportunities. These may consist of franchises such as park concessions, publicly-owned golf courses, marinas, and the state fairgrounds. Within food services, there are opportunities for beverage pouring rights. Advertising revenue can accrue from marketing certain state sites, naming rights, or Internet sites, according to carefully crafted policies.

**PRINCIPLE V: THE STATE SHOULD UPDATE THE YIELD OF MISCELLANEOUS REVENUES BY ADJUSTING FOR INFLATION**

Miscellaneous revenues as defined here includes all of those revenues to the state budget not comprising the biggest five—personal income, corporate income, general sales, insurance premium taxes, and worker's compensation taxes. Miscellaneous revenues only comprise a small fraction of the state general fund budget for FY04. This includes such items as alcohol, gasoline taxes, and tobacco taxes. The main components of miscellaneous revenues are luxury sales—\$65 million; estates—\$36 million; licenses, fees, and permits—\$108 million; interest on state bank accounts—\$23 million; total lottery—\$260 million; internal transfers and reimbursements—\$25 million; and other—\$2 million.

There appears to be no single comprehensive source of information from which to obtain all data about all state fees, fines, and miscellaneous taxes. Staff from OSPB, JLBC, and DOR confirm the fact that no such list exists.

These miscellaneous revenue sources are also very complex, increasingly so each year, and not part of any discernible long-range financial plan. Miscellaneous revenues are a patchwork built over the years in response to dozens of issues, creative ideas, and needs. Very often a public need would seem to find a revenue source related to it (or not) to fill it. Several revenue sources are the results of citizen initiatives or state referendums. This makes the management of these revenues administratively difficult and a problem for responding to changing circumstances because of Proposition 108. Further, these revenue allocations have no strategic objectives, no measures, nor any particular accountability for meeting any specific public expectations.

## **JUSTIFICATION FOR INDEXING PER UNIT TAXES FOR INFLATION**

The purchasing value of a flat per unit tax such as “cents per gallon” erodes over time if the growth in the taxed commodity does not match the growth demands of its public programs. (This assumes spending controls and good management of the public programs.) Revenue growth occurs through greater unit transactions due to population growth and larger usage. The same growing population often means the needs of the public programs are growing as well, such as transportation systems or the cost of indigent health care. Unless the market growth matches program needs, a needs/resources imbalance occurs. Where these dedicated revenues only intend to fund these programs partially, any imbalance not corrected is picked up by the state general fund. State general taxes then have more demands upon them pushing them up. The most recent example is Proposition 204, where tobacco settlement dollars are now not covering increased AHCCCS eligibility costs.

What is usually missing in the tax growth to program growth comparison is a lack of adjustment for inflation. Growth in public programs must accommodate both volume growth and costs for inflation. Flat per unit taxes only grow based on volume growth. To re-balance revenues, an adjustment for inflation should occur periodically. This ought not to be a mindless, automatic adjustment. Taxes are still based on spending. Having done that analysis of basic need, the per unit tax rates should be adjusted as minimally necessary for inflation. “Adjusting for inflation” is the result, but the true driver is the cost of the public programs, their strategic objectives, and their accountability for reaching their objectives.

Some public programs have unusual economic drivers. A prime example is the gasoline and use fuel tax that supports state and local transportation programs, known as HURF. Some VLT and other revenues go to HURF. Simply updating the gasoline per gallon tax for inflation, which has not been raised since 1990, would increase it from 18 cents to 25.3 cents per gallon. However, what is driving the need side is several dynamics at once. The average fuel economy of vehicles has increased from 13 miles per gallon in 1975 to 19.6 in 1998. More highway miles are traveled and more highway use occurs per vehicle. Arizona urbanization, stacked intersections, multiple lane widths, increased bridges, safety facilities, highway renovations, and law enforcement drive up costs. Maintenance and operational costs increase. Highway standards improve, including urban area sound barriers and rubberized asphalt to meet higher public expectations. Some of that cost increase is offset by technology and economies of scale. However, tax dollars per gallon do not stretch to all these new standards and do not meet all the needs for expanded systems. That is why updating per unit rates for inflation becomes necessary to rebalance resources to 21st century public transportation systems. Otherwise, the burden falls to the state general fund, or to county, city, or town general funds. Perhaps critical transportation programs are not built as quickly, and transportation that supports our economy becomes less efficient.

## **TAXES TO BE CONSIDERED FOR UPDATING FOR INFLATION**

- ❖ Tobacco taxes in 2007
- ❖ Jet fuel excise and use tax
- ❖ Pari-mutuel tax
- ❖ Water craft license tax
- ❖ Underground storage tank tax
- ❖ Water use tax
- ❖ Motor vehicle fuel tax
- ❖ Use fuel tax
- ❖ Aviation fuel tax
- ❖ Motor carrier fee
- ❖ Liquor tax
- ❖ Alcohol beverage license fee

### **Other Measures**

- ❖ Voter referendum to repeal alternative fuel subsidy law
- ❖ Market state lottery games
- ❖ Verify state trust lands earnings policies
- ❖ Department of Gaming — Audit and verify Proposition 202 revenue due to state

## **TOBACCO TAXES**

Tobacco taxes provide a good illustration of the revenue effects of not indexing tax rates. The State of Arizona taxes cigarettes, cigars, and tobacco at specific amounts based on volume. The largest single source is the tax on cigarettes, for which the rate was 58 cents per pack prior to the enactment of Proposition 303. From FY 1999-2002, State tax rates on tobacco products did not change. Total revenue collected for FY 2002 was \$212.4 million, which actually represented a decline of nearly \$5.3 million from FY 1999, despite population growth. However, if tax rates had been indexed for inflation since FY 1999, collections would have been \$238.7 million in FY 2002, an increase of \$26.3 million. In 2002, voters approved doubling the tobacco tax rates and allocating the proceeds to health care. The tax on a pack of cigarettes increased by 60 cents to \$1.18 per pack. Despite this major increase, without indexing, the revenue base from tobacco taxes is programmed for steady declines in real terms. To the extent this represents fewer people smoking, that is both a public health success and one purpose of “sin” taxes. A long-term fiscal solvency plan needs to be drafted, preparing for these possible outcomes.

These expected revenue declines create two issues. First, they reduce support for the specific problems that tobacco tax revenues are intended to help resolve. Of the total tobacco revenue collected from FY 1999 through FY 2002, nearly 69% was allocated to health care programs, a little over 27% for education, and almost 4% for corrections. The 2002 increase was directed entirely to health care programs. All of these core state programs experienced increased costs due to inflation from FY 1999 through FY 2002 that were not matched by similar increases in dedicated revenues from tobacco and alcohol. In particular, health care programs were subject to medical inflation rates that were one-and-a-half to two times greater than the general rate. The 2002 voter-approved increase in large part only restored this revenue erosion. It was not revenue available as a truly new funding source for health care. The real decline in tobacco tax revenue, therefore, meant that an additional \$36 million burden was placed on the state's general tax revenues from FY 1999 through FY 2002. Proposition 204 was supposedly going to cover increased AHCCCS costs with tobacco settlement funds. That program is now a huge new burden on the general fund.

The second problem is that such real declines undermine any social purpose for such “sin” taxes. To the extent that taxes on tobacco, alcohol, or any other undesirable activity are intended to discourage those activities, failing to index the tax rates dilutes their effect.

## **GENERAL FUND**



### **Insurance Premium Taxes**

Since these taxes are already a percentage, generally 2% of net premium income, they are not recommended for indexing. This revenue raised is about \$202 million in FY 01. Increases will continue to track population growth and the expansion of the insurance industry.

No changes are recommended.

### **Rental Occupancy Tax**

Rental occupancy tax applies only to leases entered into prior to December 1, 1967. The rate is 3% of the tenant's rent. This tax only raised \$82,743 to the general fund in FY 2001.

No changes are recommended.

### **Severance Tax on Timber**

Changes in proceeds for this tax, reducing FY 01 collections to \$1,095 total made the tax probably less than the cost of collection and enforcement by DOR. Consideration should be given to repealing this tax.

### **Severance Taxes on Metalliferous Minerals**

Severance taxes on the mining of gold, silver, copper and other ores have generated a high of \$41 million in collections in 1996 down to a low of \$4.2 million in 2001. The state's portion of this tax has been phased out with only payments coming to cities and counties. The copper industry has been depressed, subject to periodic market shifts. The 2.5% rate is based on 50% of the difference between the gross value of production and production costs. These "costs" should be subject to annual audit by DOR. Since this is a percentage tax, it does not need to be indexed. Perhaps the \$100 per year fee for "active mining claims" should be updated to the actual cost of handling these claims.

### **Jet Fuel Excise And Use Tax**

The first \$10 million gallons of jet fuel sold in Arizona, except overseas flights, are subject to a 3.05 cents per gallon state use tax. Anything over \$10 million gallons per year is not subject to this tax. The total amounts raised in FY 2001 were \$6.6 million.

The flat tax rate per gallon should be indexed for inflation and/or the tax cap considered for removal.

## **Pari-Mutuel Tax**

The three thoroughbred and three greyhound racing tracks in Arizona have generally been a declining industry over the past 10 years. Pari-mutuel taxes based on 2% of horse track revenue and 5.5% of dog track daily handle totaled \$8,004,351 in 1991, but only \$1,893,838 in 2001. Various tax reductions and re-investment of state taxes back into the racing industry have left nothing coming to the general fund. Casino gambling and sports entertainment venues are competitors leading to declining attendance at racetracks nationally.

The consultant's study on licenses should update the accounting of the cost of license fees for track owners and other licensed personnel in the racing industry.

This consultant study should determine what the racing industry is doing in other states to cope with economic competition. Racing is traditionally a tax producing industry now on tax-subsidized life support. Part of that outside review should include new entrepreneurial approaches that do not include casino games. The public has spoken on the issue of trying casino games to racetracks. However, new entrepreneurial partnerships perhaps with the state lottery or resort-tourism promotions can bring in out-of-state dollars. A spring or fall racing season with races tied to lottery drawings might generate more public interest.

However, if the industry continues to decline inexorably, state revenues should not be used to keep this industry alive when market forces will not. The industry should consolidate to fewer venues, simulcasting to other off-site wagering locations.

## **Aircraft License Tax**

Non-commercial Arizona-based aircraft are subject to a .5% of fair tax market value annual tax, deposited to the state aviation fund. The tax raised \$3,176,000 in FY01.

Since it is a percentage tax, no change is recommended.

## **Flight Property Tax**

Commercial aircraft based in Arizona pay an *ad valorem* property tax to the state aviation fund and the general fund. The property is class 5, with a minimum rate of 21%. In FY 01, \$13,387,179 was collected, split equally between the aviation and general fund.

No change is recommended.

## **Vehicle License Tax**

The Vehicle License Tax is an *ad valorem* personal property tax on 10 classes of registered vehicles and vehicle trailers in the state. The tax formula is complex but the base generally declines from 60% of base price by 16.25% each year as the vehicle depreciates. Thus, the formula is progressive for lower original cost

and older vehicles. The tax rates are \$2.80 per \$100 assessed value for new vehicles and \$2.89 per \$100 assessed value for renewals. Vehicle owners are allowed to register only every two years if they pay the amounts due for both years up front. While there is no actual discount to the registration, the fact that the tax bill for the second year is always lower than the amount due for the first year because of depreciation likely leads many to believe that, in fact, they are receiving a discount. The state general fund received a high of \$168.8 million in 1998 before beginning a three-year phase out. Without that phase out, the state would be receiving about \$200 million in the current fiscal year. However, the VLT is generally considered high by taxpayers and possibly higher than nearby competition states. Whether this leads to meaningful economic dislocation, effects along state borders could be researched. High rates may lead to scofflawing on registration and VLT, which is an enforcement problem for ADOT and results in permanent lost revenues. VLT revenues support state and county highway funds, and county, city, and town general funds, allocated on a percentage formula basis. For all purposes, revenues in FY01 totaled \$570,7769,364.

VLT is already assessed on a percentage basis, and no changes are recommended.

### **Watercraft License Tax**

Watercraft license tax laws require numbered registration of all non-exempted watercraft of any type used on the waters of the state. The tax formula is a flat but stepped-up rate above 18 feet in length. The resident rates are 0 to 18 feet—45 cents per foot. Above 18 feet—68 cents a foot. Out of state rates are \$1.40 a foot to 18 feet and \$2.75 a foot over 18 feet.

Of the total funds received, 45% is deposited to the Watercraft Fund for enforcement and boating safety education, 55% is deposited to the Game and Fish Dept for lake improvements and boating safety and enforcement.

These license fees are dedicated funds to pay for regulating licensing, education, and safety. Pursuant to a strategic plan for these services and full cost recovery, these fees should be adjusted to pay for those activities without general fund support. Converting to progressive percentage taxes should be considered instead of flat rates. Such review should be updated at least every 5 years.

### **Intrastate Utility Corporation Assessments**

Utility assessments are imposed on all non-public sector utilities with gross revenues over \$250,000. Railroads are exempt. These annual fees cover the cost of the operation of the Utilities Division of the Corporation Commission and the Residential Utility Consumer Office (RUCO). Fees are adjusted annually according to actual needs. Total collections for FY 2001 were \$9,899,000. Total assessments may not exceed 0.2% of operating revenue for any company.

Since these fees are for well-defined purposes, updated annually by subtracting from available fund balances, with everything appropriated by the Legislature, this system works well.

It does not need updating for inflation and presents no burden on the state general fund.

### **Lieu Tax on Worker's Compensation Insurance Premiums**

The lieu tax on worker's compensation premiums is 3% of net premiums or not less than \$250 paid by employers for worker's compensation coverage. The revenues pay for administrative expenses of the Industrial Commission and the special fund which pays for services to help disabled workers. The special fund can also pay for offices or an office building for the Industrial Commission. Annual assessments for both funds are no more than necessary to keep these funds actuarially sound.

These funds do not require general fund support, are updated annually, and do not need adjustment.

### **Telecommunications Services Excise Tax**

The Telecommunications Services Excise Tax pays for emergency telephone services, the fund for the deaf and hearing impaired, and the poison control fund.

Emergency services are provided 37 cents per activated telephone or wireless line. The fund for the deaf receives 0.8% of gross revenue and the poison control fund 0.3% of gross revenue. Total proceeds for FY 2001 were \$18,891,231.

Funds are drawn annually from revolving funds.

These are not supported by the general fund and are self-sufficient.

No change is recommended.

### **Underground Storage Tank Tax**

This tax of 1 cent per gallon for petroleum and other stored, regulated products goes to an assurance account and a grant account. The purpose is environmental remediation for leaking storage tanks. Tank operators are subject to a \$100 annual license fee. Total collections for FY 2001 were \$30,025,484.

Since this is a per unit tax, consideration should be given, when necessary, for updating this revenue source to meet actual costs.

## **Unemployment Insurance Tax**

Unemployment insurance tax laws require all non-exempt employers to pay into the State Unemployment Compensation Fund. Generally, the tax rate is 5.4 a year, with 1% going to a state worker training fund. Annual assessments vary based on the employers' use of the proceeds of the fund. Lack of any use in the previous year drops the pay-in rate to 2.7%, via a graduated scale. The fund raised \$173,563,536 in FY 2001, which included \$5,529,203 of federal funds.

No changes are recommended.

## **Water Use Tax**

Municipal water delivery systems pay .65 of 1 cent per 1,000 gallons of water delivered into the Water Quality Assurance Revolving Fund. This fund assures water quality of delivery systems. The tax raised \$2,120,483 in FY 2001.

This flat rate tax may be needed to be updated for inflation.

## **Motor Vehicle Fuel Tax**

The "gas" tax has been a flat 18 cents per gallon since 1991. It raised \$436 million in FY01, and \$446 million FY03. This raises about \$25 million per penny. All except 4.3% goes to the Highway Users Revenue Fund. This fund provides construction, maintenance, and law enforcement support for state and local roads according to a complex distribution formula.

Virtually everyone pays fuel taxes relatively proportionately to their actual use of state roadways, on a pay-as-you-go basis.

Consideration should be given for updating this tax for inflation. This measure should be tied to an anti-price gouging statute that lasts as long as Arizona is essentially single supplier dependent.

## **Use Fuel Tax**

Collections of the use fuel tax totaled \$155,859,243 for FY 2001. This tax supports the HURF fund just as the motor vehicle fuel tax does. The tax rate is 18 cents a gallon for vehicles up to 26,000 pounds and 26 cents per gallon for vehicles over 26,000 pounds. The tax applies to diesel and other non-gasoline motor fuels, with a few specified exceptions.

Since this tax is a per gallon tax, it should be updated for inflation.

## **Aviation Fuel Tax**

Aviation fuel tax is a 5-cent per gallon tax for aviation fuel used by non-jet and non-turbine internal combustion engine aircraft. The total raised for FY 2001 was \$456,476 and is deposited in the State Aviation Fund.

Consideration should be given to updating this tax rate for inflation.

## **Motor Carrier Fee**

The motor carrier fee is a “fee” with really more of the characteristics of a tax. It is levied on motor carriers with weights of 12,000 up to 80,000 pounds, that use public roadways. The tax rates are determined by weight up to a maximum of \$800 per year. A major overhaul of the motor carrier tax system occurred in 1997, and revenues dropped from \$92,563,879 in 1997 to \$34,139,960 in 1997. For FY2001, the collection was \$32,677,923. The reduction was off set by an increase in the Use Fuel Tax. A weight and distance tax was replaced by a stratified weight graduated fee. Out-of-state single trip fees were increased.

These fees should be updated for inflation.

## **Liquor Tax**

The liquor tax is a holdover from the “sumptuary” tax philosophy as a luxury consumption tax on liquor, wine, and malted beverages. According to the Department of Revenue, these taxes have not been updated since 1984.

Proceeds from this tax are distributed to several funds, as follows:

General Fund & State School Aid FY 2001 — \$22,443,910	1.17% of spiritous tax 14% of wines over 24% alcohol by volume
Corrections Fund FY 2001 — \$19,294,778	20% from spiritous liquor 50% from wines and malted beverages
Wine Promotional Fund FY 2001 — \$21,278	First \$100,000 from low alcohol content from in-state producers
Drug Treatment and Education Fund FY 2001 — \$6,903,464	7% of spiritous liquor and 7% from wine and malted beverage industry
Corrections Revolving Fund FY 2001 — \$2,743,924	3% from spiritous liquor and 7% from wine and malted beverage industry
FY 2001 — Total \$51,407,354	

The tax is collected on producers and wholesalers.

Tax rates are fixed, as follows:

- ❖ Spiritous liquor — \$3 per gallon
- ❖ Vinous liquor high (24%) alcohol content — \$.25 per 8 oz.
- ❖ Vinous liquor low alcohol content \$.84 per gallon
- ❖ Malt liquor or cider \$.16 per gallon or beer or cider (6%) alcohol content or less.

These taxes should be indexed for inflation.

### **Alcoholic Beverage License Fees**

Alcoholic beverage fees are charged to all non-exempt sellers, producers, or importers of alcoholic beverages to pay for regulation of this industry. Total licenses are restricted by county population. Fees vary by type of seller or producer. Revenues are distributed to several funds as follows:

Club licenses — FY 2001 — \$44,175	DES Mental Retardation and Capital fund
---------------------------------------	--

Special Event Licenses FY 2001 — \$47,950	Health Department for treatment of alcoholics
--	--

Other licenses  
General Fund FY 2001 — \$3,876,428

Counties FY 2001 — \$346,375

Audit Surcharge FY 2001— \$93,840

Enforcement Surcharge FY 2001 — \$525,050

The erosive effects of inflation on these dollars that support corrections, health, or drug and alcohol treatment programs means more funding must come from the state general fund.

Real declines in purchasing power for revenue compared to the program being supported undermines the social purpose of “sin” taxes. To the extent fixed taxes on tobacco or alcohol or other undesirable activity are intended to discourage those activities, failing to index for inflation dilutes the effect of dampening demand for those activities. These taxes should be compared for competitive purposes to other Western states.

These taxes should be indexed for inflation.

## **STATE LOTTERY**

The state lottery was implemented by Initiative Petition approved at the November 4, 1980 election.

It was amended by Initiative, Proposition 203, in 1996, which passed.

The lottery will conditionally terminate on July 1, 2012, unless continued.

According to a report in the publication Public Budgeting and Finance, Summer 2003 edition, 37 states have state lotteries that offer both instant and periodic drawing-type games. On a percentage of state revenues comparison, the Arizona lottery provides .64% of state government revenues, which is 25<sup>th</sup> out of the 37 states (based on year 2000 data). See enclosed chart.

Arizona lottery sales are distributed as follows: player prizes 54.3%, funding of various state programs 29.5%, lottery operations 9.4%, retailers compensation 6.8%. Lottery revenues have flattened in recent years. According to the Public Budgeting and Finance reports, some states have increased instant scratch-off and other on-the-spot games. These include keno, bingo, cash for life, video lottery, and the “sports action” games in Oregon. There also seems to be a positive correlation between higher percentage payouts of sales to growth in lottery sales. Payouts are usually in the 50% range. Public support nationwide of lotteries is about 70%, even though people realize chances of winning are very low, and that lotteries are regressive taxes on the poor. It is part of the common experience and civil culture of America, especially the now widely publicized “powerball” payouts.

Arizona lottery collections have declined in FY03 and FY04 from \$294 million in FY02 to \$260 million for both '03 and '04. A new entrepreneurial approach to lottery games is needed if proceeds are to keep up just with state population growth on a percentage basic. New ideas for in-state and out-of-state marketing opportunities ought to be considered. Partnering with the state racing industry for Arizona-bred horses is a typical idea. A creative team within the lottery department can devise these approaches.

There is statutory limitation of spending no more than 4% of the total annual gross lottery revenues on promotion or advertising. In FY 1996, the Lottery spent approximately 3.8% on the average on advertising/promotion. In FY 2000, that amount was reduced to 2.7%.

The previous policy for the last five years concentrated on promotion of the lottery's beneficiaries and the good that the lottery does for the state.

A new policy will apparently have a new strategy, which will be to do product marketing, focusing on selling the products, and trying to maximize the revenue that is returned to the state. This strategy started on July 1 of this year.

State lottery games for all their shortcomings, are supported by a majority of the public and should be marketed.



**TABLE 1**  
**Lottery Proceeds as a Percent of State Total Revenue**  
**(ranked by highest percentage of total revenue)**

State	Proceeds Available from Sales (in thousands of dollars)	Total Revenue in 2000 (in thousands of dollars)	% Total Revenue from Lottery Proceeds
Delaware	270,697	5,161,880	5.24
South Dakota	100,589	2,872,648	3.50
Oregon	583,832	21,228,218	2.75
Rhode Island	146,787	5,530,382	2.65
Massachusetts	838,968	32,010,543	2.62
Georgia	677,432	29,629,804	2.29
Maryland	407,590	21,228,218	1.92
Florida	899,357	51,629,704	1.74
New Jersey	712,947	42,431,299	1.68
West Virginia	136,449	8,541,689	1.60
Connecticut	257,355	17,707,206	1.45
Ohio	785,354	55,273,628	1.42
New York	1,445,636	111,397,057	1.30
Pennsylvania	704,114	54,517,356	1.29
Michigan	614,037	49,511,738	1.24
New Hampshire	60,417	4,993,168	1.21
Texas	877,554	72,322,692	1.21
Illinois	508,363	48,524,287	1.05
United States	12,397,560	1,259,835,410	0.98
Kentucky	158,325	19,450,661	0.81
Indiana	161,772	20,456,388	0.79
Missouri	157,430	20,309,319	0.78
Virginia	226,548	28,902,064	0.78
Maine	43,346	6,293,691	0.69
<b>Arizona</b>	<b>106,560</b>	<b>16,720,578</b>	<b>0.64</b>
Vermont	19,240	3,291,905	0.58
Louisiana	97,184	18,404,332	0.53
Colorado	88,104	17,059,603	0.52
California	885,915	172,480,675	0.51
Kansas	50,516	10,325,693	0.49
Wisconsin	115,220	32,118,867	0.36
Washington	100,848	30,615,762	0.33
Idaho	17,973	5,576,304	0.32
Iowa	36,789	11,339,583	0.32
Nebraska	15,656	6,136,293	0.26
New Mexico	24,824	10,570,408	0.23
Minnesota	57,250	26,888,792	0.21
Montana	6,582	4,204,317	0.16
Average for 37 states			1.23

Source: The U.S. Census Bureau for the year 2000. Available from: <http://www.census.gov/govs/state>.

## **DEPARTMENT OF GAMING**

Proposition 202 voted in on November 5, 2002, contained the following provisions:

### **Gaming Revenues Contributions**

Indian tribes contribute from 1% to 8% of their Class III Net Win (graduated on Net Win size) to pay for state gaming administration, designated programs, and state and local governments.

Class III Net Win is the difference between gaming wins and losses, before deducting costs and expenses. Class III gaming typically includes games found in casinos. Types I and II gaming generally are smaller games of chance such as bingo and traditional Indian games of chance and are not included in the gaming compacts.

Operating expenses are not included in calculating the Net Win. The calculation of Class III Net Win appears to be relatively simple and straightforward.

### **Independent Audits:**

The Indian Tribe-State compact requires the Gaming Operator to obtain an annual audit, including an audit of the tribe's Class III Net Win. The audit must provide an attestation by the auditor that Class III Net Win is accurately reported. The auditor must be a CPA, registered with the Arizona Board of Accountancy. The audit must be conducted in accordance with generally accepted auditing standards.

The audit report is first provided to the Tribal Gaming Office and subsequently to the State Gaming Agency. The State Gaming Agency has the right to confer with the auditors and to review their workpapers. Provision for independent validation of Net Win appears adequate.

### **Distribution of Contributions:**

The Arizona Benefits Fund Receives 88% of the total annual contributions based upon Class III Net Win. The Arizona Benefits fund is administered by the State Gaming Agency. The is to be used for administering the contributions made by the tribes (including oversight). Distributions from the fund may only be made in accordance with provisions set forth in the November 5, 2002 election. The state may not impose any tax, fee, charge, or other assessment upon the Tribes' gaming operations.

Distributions by tribes to cities, towns, and counties receive the remaining 12%. This 12% contribution will be distributed at the Tribe's discretion to either or both of the following:

- Distributions to cities, towns, or counties for government services that benefit the public good, including public safety, mitigation of impacts of gaming, or promotion of commerce and economic development.
- Distributions to the Commerce and Economic Development Commission Local Communities Fund. The Tribe may elect to allocate all or a part of its (12%) contribution to this fund. The commission will award monies from this fund in the form of grants. Monies a tribe contributes to this fund will be placed in a sub-account in the tribe's name. The tribe will receive an annual accounting of the sub-account, including opening balance, deposits, awards, closing balance, and the projects for which funds were awarded. The tribe will have the opportunity to comment on the granting of monies from the sub-account and all grant applications must have the written endorsement of a nearby Indian tribe to receive an award of funds from the commission.

With regard to distribution of contributions, tribes do exercise significant discretion. It appears that local governments will not be able to depend on gaming contributions because tribes may elect to allocate some or all of the contribution available to local governments to the Commerce and Economic Development Commission Local Communities Fund. This Commerce and Economic Development Fund requires awarding money to grant applications that have obtained tribal sponsorship.

With regard to the percentages being contributed, the 1% - 8% figure seems quite low. In Connecticut and New York, 25% of gaming proceeds accrue to the state. Consideration should be given to reviewing Arizona's percentages after five years.

## **PROPOSAL TO AUTHORIZE A PUBLIC VOTE TO RESCIND ALTERNATIVE FUEL SUBSIDY LAW**

The year 2000 Legislation to provide state taxpayer subsidy for the purchase and operation of propane, compressed natural gas, or electric-powered alternative fuel vehicles was obviously a financial disaster to the state. Originally projected to cost no more than \$10 million, the law was finally cut off for approved users for a total cost (thus far) of about \$200 million. About 19,200 vehicles entered the program before it was capped. From the standpoint of intervening in the marketplace by trying to pick technological winners, the law was inept. The law subsidized General Motor's EV-1 electric vehicles through their leased periods. These vehicles have not caught on with the public and are now being retired as leases run out. Due to the loopholes for "dual fuel" vehicles, gasoline cars and trucks with small subsidiary alternative fuel tanks also received the tax credit.

The program continues to cost the state about \$6.3 million every year in reduced registration fees and motor vehicle taxes. An opportunity for the voting public to speak on this issue should be offered via a referendum question in 2004. Alternative fuel users have received their cash subsidies, and there is now no further public policy advantage for continuing it. There is no longer any "net present value" to continue this subsidy, especially as the program has already been limited as air pollution control policy.

According to Maricopa County Department of Environmental Services estimates, the pollution abatement cost about \$8,100 of taxpayer subsidy per ton of air pollution prevention. Unfortunately, with 100,000 people a year coming to Maricopa County, there are as many new gasoline vehicles added to county roadways every six months as are in the entire current alternative fuel program. Trip reduction, voluntary vehicle repair and retrofit, dust control, and other means are far more cost effective - between \$180-\$800 per ton.

The opportunity to recoup this \$6.3 million should be pursued. This potentially recouped revenue should become a state revenue and not shared with local governments. The state administers this tax, therefore, lacking any incentive to administer it well without a stake in the revenue accruing from the tax. Further, new hybrid vehicles such as gasoline-electric are coming out, which do not qualify for this program. This makes the existing policy discriminatory, among other flaws. The current gasoline shortage only highlights that market forces should cause consumers to make choices on fuel types.

Since alternative fuels are not taxed, consideration should also be given to taxing alternative fuels at the standard motor vehicle tax rate of 18 cents per gallon or per gallon equivalent.

**(APPENDIX 1)**

**REVENUE FROM FEES, CHARGES & INTEREST**

	State & Local Total (in millions)	State Share (vs. Local)	Total Per Capita	Per Capita Rank	Misc. as % Total Revenue	% Total Revenue rank
ALABAMA	\$6,510	44.5%	\$1,464	14	25.3%	3
ALASKA	5,320	88.5	8,484	1	50.5	1
ARIZONA	5,054	40.3	985	50	18.2	37
ARKANSAS	2,798	54.1	1,047	49	20.2	28
CALIFORNIA	49,830	31.8	1,471	11	18.4	36
COLORADO	6,508	39.2	1,513	9	22.0	14
CONNECTICUT	3,784	70.5	1,111	44	14.6	50
DELAWARE	1,754	78.3	2,237	3	28.2	2
FLORIDA	22,209	29.6	1,390	20	24.0	08
GEORGIA	9,367	36.6	1,144	42	19.2	33
HAWAII	1,696	74.7	1,399	19	20.0	30
IDAHO	1,632	46.0	1,261	30	21.5	16
ILLINOIS	13,373	43.0	1,077	46	16.6	45
INDIANA	8,217	46.3	1,351	22	25.1	5
IOWA	4,158	47.5	1,421	17	24.1	7
KANSAS	3,292	39.8	1,225	33	20.3	27
KENTUCKY	4,655	56.1	1,152	41	18.5	35
LOUISIANA	6,385	56.0	1,429	16	23.6	9
MAINE	1,547	68.3	1,214	36	18.1	39
MARYLAND	6,177	55.7	1,166	40	18.2	38
MASSACHUSETTS	7,814	70.1	1,231	32	16.9	44
MICHIGAN	14,610	50.4	1,470	12	20.8	21
MINNESOTA	8,015	39.7	1,629	5	20.7	23
MISSISSIPPI	3,762	38.7	1,322	23	22.6	12
MISSOURI	5,963	44.6	1,066	48	18.8	34
MONTANA	1,419	62.0	1,573	8	25.1	4
NEBRASKA	2,337	49.5	1,366	21	20.1	29
NEVADA	2,534	27.6	1,268	28	21.3	17
NE HAMPSHIRE	1,414	72.3	1,144	43	20.4	26
NEW JERSEY	10,784	58.9	1,282	27	17.3	42
NEW MEXICO	2,863	68.4	1,574	7	21.9	15
NEW YORK	27,784	37.8	1,464	13	14.7	49
NORTH CAROLINA	10,640	36.2	1,322	24	21.1	20
NORTH DAKOTA	1,020	61.1	1,589	6	22.7	11
OHIO	13,846	46.3	1,220	34	17.3	43
OKLAHOMA	4,266	44.5	1,236	31	22.7	10
OREGON	6,324	54.8	1,849	4	22.1	13
PENNSYLVANIA	15,536	55.7	1,265	29	19.3	31
RHODE ISLAND	1,139	79.7	1,087	45	15.3	48
SOUTH CAROLINA	5,808	44.0	1,448	15	24.7	6
SOUTH DAKOTA	886	63.4	1,173	39	20.7	22
TENNESSEE	6,072	34.1	1,067	47	18.1	40
TEXAS	24,737	43.4	1,186	37	20.5	24
UTAH	3,163	57.8	1,416	18	21.1	18
VERMONT	718	75.5	1,179	38	17.9	41
VIRGINIA	9,341	60.0	1,320	25	21.1	19
WASHINGTON	8,865	39.4	1,504	10	19.1	32
WEST VIRGINIA	2,203	58.2	1,218	35	20.5	25
WISCONSIN	6,966	55.6	1,299	26	16.2	47
WYOMING	1,159	46.4	2,346	2	16.5	46
DC	769	—	1,344	—	12.0	—
US	377,022	45.3	1,340	—	19.4	—

Source: National Conference of State Legislature

(APPENDIX 2)

**Cost Allocation/Fee Study Consultants and Software Companies**

<b>Consultants</b>	<b>Website (Home Page) or contact number</b>
FCSGroup	<a href="http://www.fcsgroup.com">www.fcsgroup.com</a>
Miller & Associates	360-943-3885
Miller & Miller Consulting Services	206-281-0281
Maximus	<a href="http://www.maximus.com">www.maximus.com</a> Contact: Joel Nolan 602-249-9807
Henry & Horne PLC	480-839-4900
Accenture	602-337-4000
Deloitte & Touche	602-234-5100
Cap Gemini Ernst Young	602-452-5900
<b>Software Companies</b>	<b>Website (Home Page) or contact number</b>
SAP Public Services Inc.	<a href="http://www.sap.com">www.sap.com</a>
PeopleSoft	<a href="http://www.peoplesoft.com">www.peoplesoft.com</a>
Acorn Systems	<a href="http://www.acornsys.com">www.acornsys.com</a>
HGI Software Inc.	<a href="http://www.hgisoftware.com">www.hgisoftware.com</a>
Government Software Systems, LLC	<a href="http://www.gss-software.com">www.gss-software.com</a>

(APPENDIX 3)

**Check List of Ideas from the  
“Miscellaneous Revenues Report”**

- Keep general state taxes low; implement all miscellaneous revenues first to their maximum potential and then adjust general state taxes last as part of the budget.
- Miscellaneous revenues includes maximizing all fees and charges, interest earned, fines, donations, grants in aid, and internal service funds within an overall fiscal discipline.
- Mere “revenue starvation” of government means taxpayers pay more in the long run. Good governance requires managing the spending side at all times.
- State should use a ten-year financial forecast for both revenues and expenditures.
- The state should engage professional accounting firm to conduct a complete statewide user fees study.
- User fees should exchange licensing and regulatory performance standards in exchange for full funding of licensing and regulatory costs.
- Maximize interest income by increasing the frequency of deposits, using bank lock boxes, and transmitting fund balances daily.
- Interest income can be increased by more careful cash analysis, calendarizing, and combined with longer-term investments.
- State should engage a comprehensive revenue leak stoppage effort. State should scrutinize revenue leaks from the underground economy, scofflawing, and from new residences and businesses.
- State Department of Revenue should increase staffing and technology to the point of diminishing returns.
- The state should establish a special task group comprised of representatives from the DOR, the Auditor General, JLBC, and OSPB to look for and close all revenue leaks.
- The state should establish a single inventory of all miscellaneous revenues for comprehensive annual review.

- The state should create a low, likely, and high method of estimating miscellaneous revenues.
- Simplify or eliminate many of the tax law provisions that are overly complex, administratively costly, and not fully accountable for results.
- Incentivize state and local employees to collect certain revenues and use private collection companies.
- Maximize revenue opportunities through franchises, public bids on food service, beverage pouring rights, advertising of state on state properties, naming rights, internet sites according to carefully crafted policies.
- The state should update the purchasing value for certain miscellaneous tax revenues by adjusting for inflation, focusing on per units of measure type taxes. Tie this to a referendum question that also indexes the state personal income tax brackets for inflation.
- The state lottery should be marketed in addition to creating new games to generate public interest. Possibly partner with Arizona race tracks to stimulate cross industry interest.
- Carefully audit Proposition 202 gaming revenues, and state contracts with the Native American Tribes. Consider updating the percentages to state government after five years.
- Offer a public referendum to eliminate the remaining revenue loss from the alternative fuel subsidy law. Consider taxing alternative fuels at the motor fuel tax rate.